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Get Real About Your Future

Our five experts offer compelling advice on coping with the prospect of lower returns and longer working lives.



Retirement planning isn't rocket science, but it isn't as easy as it used to be. Among the challenges: a stagnant stock market, low interest rates, and looming cut-backs in Social Security and private pensions. To help you sort through these difficult issues, FORTUNE's Julia Boorstin assembled a panel of top-flight investment thinkers: Alison Deans, chief investment officer at a private-investment division of Lehman Brothers; Harold Evensky, of the financial-planning firm Evensky & Katz in Coral Gables, Fla.; Jeremy Siegel, finance professor at the Wharton School of the University of Pennsylvania and author of *Stocks for the Long Run* and *The Future for Investors*; Allen Sinai,

BRAIN TRUST Allen Sinai (left), Quinn Stills, Jeremy Siegel, Alison Deans, and Harold Evensky

chief economist and strategist of Decision Economics in Boston; and Quinn Stills, the founding partner of Palisades Investment Partners, a pension-management firm in Santa Monica, Calif. While their overall outlook is sobering, they offer a lot of valuable guidance that can help you achieve a prosperous retirement, despite the obstacles. Here are edited highlights of the panel's conversation.

Let's start with the big question—are people going to be able to have a prosperous retirement?

EVENSKY: Traditionally, we talked about retirement as a three-legged stool: Social Security, pensions, and personal savings. We don't think the stool is going to exist. Social Security is questionable. Defined-benefit pensions are not going to be there. And as a country we have very little in personal savings.

So we're beginning to see a rethinking of the whole concept of what we've called retirement. Many people simply are not going to be able to have the traditional stop-working-at-65, enjoy-life-with-what-you've-saved retirement. We see a huge transition. A lot of baby-boomers are not going to be able to afford to retire, but instead of saying they can't afford it, they are going to redefine it as a positive, to keep working. It doesn't mean that we think people are going to keep the same job. We think that there will be a second leg of life. We have even very successful clients now who are looking to change the nature of what they do. We have an executive who wants to go back and teach high school math.

SIEGEL: The average American, when asked when he or she wants to retire, says, "Yesterday." The trend has always been toward early retirement. But my research says that the average retirement age could be pushed back ten years or more, depending on certain economic circumstances. Right now, the average retirement age in the U.S. is 63. It may have to rise to 73 or 75. So everyone should be planning for a later retirement than they are now. And as health-care costs continue to rise, a healthy lifestyle is a must.

Let's look at the reasons that could delay retirement, starting with stock market returns. What kind of returns can we expect over the next ten years?

EVENSKY: We think that over the next five to ten years equity returns are likely to be modest, in the 8% to 9% range. After 3% inflation, that means 5% or 6% annual real returns. Small-cap stocks might earn another percent or so. And we think international stocks will be pretty much in the same range as U.S. stocks over that period.

DEANS: My view is that returns for most U.S. asset classes will be below their past ten- and 20-year historical averages. We're coming out of a long period where you had some pretty powerful forces driving the market: a significant decline in inflation, interest rates, and taxes—all of which had a very positive effect on financial assets, particularly equity markets. At the same time, we had deregulation, and corporations really be-



gan to be more bottom line—and shareholder-oriented. All of that just provided a tremendous tailwind to the markets, and while I think some of those trends are still in place—deregulation and corporations' paying more attention to the bottom line—you don't have the same positive macroeconomic forces. As a result, it seems as if the market over the next several years will be driven a lot more by GDP growth, offset somewhat by inflationary pressures, and that's just a very different overall environment from what we got used to in the '80s and '90s. Add in the fact that we're still in the aftermath of a bubble, which makes investors more risk-averse, and the next few years will be a lot more challenging than the past 20 years have been.

SINAI: We like stocks. We just don't think they're going to knock anyone's socks off. Our view has been that we are in an equity bull market that began in the fall of 2001 and will last until late 2006 or early 2007. Our target for the S&P 500 this year remains 1275 to 1300. So we expect, over the next three to five years, muted but positive returns in the broad U.S. equity market, on the order of 5% to 8% annually. That's subpar by historical standards, but still quite adequate.

SIEGEL: My projection is 5.5% to 6% real [after-inflation] annual returns on stocks, looking long run, over 20 years. Maybe 3% or 3.5% will come

"People are simply not going to have the traditional stop-working-at-65, enjoy-life-with-what-you've-saved retirement."

Harold Evensky &
Evensky & Katz

On the Web



You can find historical data, charts, and articles by Jeremy Siegel at jeremysiegel.com. (registration required for some material).

Allen Sinai's forecasts are available at pdeeco.com. (registration required).

from dividends, and the rest will be capital gains. That's about a point below the long-run average, which is 6.5% to 7%.

Those are pretty uninspiring numbers. What can people planning for retirement do about them?

DEANS: If we're assuming that market returns are going to be below what they've been for the past 20 years, it just means that you need to start planning a lot earlier and raising the amount of money you save, rather than panicking at the age of 60. People always walk in and say, "I would love a 10% return and to never lose any money." And I say, "So would the rest of the world." That's not realistic. With our view of the world, it's almost impossible to construct a 10%-return portfolio and not have a lot of volatility or risk attached to it.

Do any particular segments of the market seem likely to provide better returns?

DEANS: Yes. Just because markets move sideways doesn't mean there aren't opportunities to do better. International markets, actually, hold a lot more appeal over the next several years than the U.S. The growth is really starting to happen overseas. So expand your horizons. And if these developing countries are really starting to develop, they're going to need to build infrastructure, which means they're going to need commodities.

STILLS: Looking at returns is very important, but looking at the risks you're taking to get those returns is equally important, especially for someone who doesn't have as much time to recover from his losses. Emerging markets have been very, very popular, one of the fastest-growing allocations for institutional pension funds over the last few years. But there have been catastrophic events in those markets that have really impaired the values; the devaluation of the Mexican peso is an example.

SIEGEL: The research I did for my latest book made me more of a value investor than before. In particular, I verified how important dividends are in boosting long-term returns. And how important reasonable valuations are. You find that a lot of the fastest-growing companies don't provide the best returns, because they're just priced too high.

EVENSKY: I'm a big believer in dividend-paying stocks, but basically the returns are total return. The dividends are just an element. Dividends can indicate that a company has good managers who aren't just blowing the money. But I want good companies that are paying dividends, not just dividend-paying stocks.

Let's talk about bonds. What impact do low interest rates have on retirement strategies?

SIEGEL: Today's low interest rates are a troublesome development for people planning for retirement, because you're not going to be able to get the income flow that you could have throughout most of the post-war period. Take the Treasury's inflation-protected securities. When they came out in 1997,



they were offering a 3.5% real return. They went up to over 4% in 2000 but in the last two years have plummeted down to 1.5%. Standard bonds are no better. The ten-year Treasury is paying around 4%, with no inflation protection. So you subtract 2.5 points for inflation, and you're back at 1.5%.

At those rates, is there any reason to hold bonds at all if you're in your 20s or 30s?

SIEGEL: My answer is no. Right now, I'd rather see someone own international stocks and dividend-paying stocks, which do very well in bear markets. In some sense, I think those are better diversification choices, offering more bear market protection than bonds.

EVENSKY: My answer is yes. Up until a few years ago, we did have some younger clients 100% in stocks. Then two things happened that changed our mind. One was the bear market of the last few years. People have infinite risk tolerance when stocks are going up and zero risk tolerance when stocks are going down; people just get scared. But if you have even a little piece of your portfolio, 15% or 20%, in fixed income, at least you have something that's not losing money when stocks are falling, and that might help keep you from panicking and selling your stocks.

Two, we believe in setting rigorous rebalancing

"For some people, the recent gains in home equity are greater than what they could save in a lifetime."

Quincy Star,
Palisades Investment Partners

Safety Net

■ In 2003, Social Security was the largest source of income, 41.9% on average, for people 65 and older, according to the Employee Benefit Research Institute.



"If interest rates go up, I'd much rather have a REIT than a bond, because I've got inflation protection."

Jeremy Siegel
Wharton School

guidelines. By being committed to having 15% or 20% in fixed income, we are forced to take some profits when stocks are going crazy on the upside. And we have some money to buy cheap when the market's going crazy in the other direction.

DEANS: Young people need houses, they have children, they have expenses. There are times they need cash, and they should have a piece of their portfolio in something that's a little bit more stable than stocks, so they don't have to sell their stocks during a downdraft. That's one benefit of diversification. To have something that smoothes out some of the ups and downs and prevents you from selling at a bottom seems prudent.

On the other hand, if someone has at least a ten-year time horizon and is sure he isn't going to need the money, I would say for a younger family, be aggressive, have absolutely no bonds. Because if the rates stay low, you're not getting much of a return. And if rates go up, the value of today's bonds will go down. I think anybody up to age 40 should essentially be 100% in stocks.

Do you see rates rising back to more lucrative levels?

SINAI: Not really. Increases in long-term rates are likely to be muted. We expect the ten-year Treasury bond to peak at about 4.75% during the first half of next year, then to decline in 2007 and 2008.

What about real estate investment trusts? The sector has been hot, and yields are still high.

DEANS: I think REITs are vulnerable. The spread between the dividend yield on the NAREIT index and the S&P 500 is about three percentage points. The all-time high is nine points, and the median is six. So the fact that the spread is just three today tells you that the sector is getting overvalued. My issue with REITs is that people are buying them for the wrong reasons, as bond substitutes rather than as real estate-related investments. Therefore,

"We like stocks. We just don't think they're going to knock anyone's socks off."

Allen Sinai
Decision Economics



if and when bond yields increase, these investors are likely to move their money back into bonds, which will depress the value of REITs.

SIEGEL: I agree that REITs are going to go down if interest rates go up. But if interest rates go up, I'd much rather have a REIT than a bond, because with a REIT I've got inflation protection built in.

STILLS: REITs have dramatically outperformed most major asset classes for the past few years. I would strongly urge investors to harvest some portion of their gains and move assets away from this category altogether.

Let's take someone in retirement who needs income. How are you constructing an income portfolio these days with yields so low?

EVENSKY: There's this common belief that you spend less money in retirement than when you were working, and that's absurd. The only thing that people have when they retire is more time on their hands, and time costs money. So they are likely to need closer to 80% or 90% of their previous income, in many cases more than that. But income doesn't have to come from dividends and interest. We start with a total-return portfolio and then figure out strategies. A lot of people get their income from capital gains on investments they've held a long time. So here's what we do. We calculate how much the couple is going to need for living expenses for the next two years, and we take that amount and put it into money-market and short-term bond funds. What that allows us to do is take the rest of their portfolio and follow a total-return strategy, where we reinvest everything. It's more cost- and tax-efficient, because there's a lot less trading going on than if we were regularly selling assets to meet living expenses.

How do you factor your home into your long-term plan?

STILLS: People may have a huge amount of equity in their homes that's materialized in the last four or five years. For some people, the recent gain in home equity is greater than what they could save in a lifetime. So I think it counts. It really is an asset, and it is part of savings.

SINAI: It's very risky, though. The published data don't show any real trouble in real estate because,

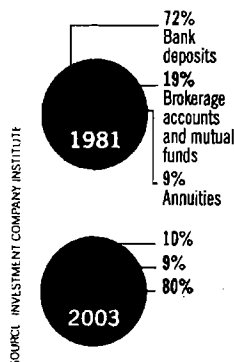


"International markets hold a lot more appeal over the next several years than the U.S. So expand your horizons."

Alison Deans
Lehman Brothers

A Better Mix

■ Americans have shifted their IRA money from banks to mutual funds and brokerage accounts.



as you know, it's an illiquid asset, and when there's a slump people hold on to it instead of selling at a low price. And there are stress times when it's a totally illiquid asset, although we're not anywhere near that right now.

DEANS: I think it's a really bad idea to factor your home in as part of your net worth—you are always going to need a place to live.

EVENSKY: Since most investors don't want to plan on having to sell their homes and live on the street in order to buy groceries, we generally do a financial plan without including a couple's primary residence. But in some cases the calculations might suggest that the couple can maintain only 60% to 70% of their standard of living in retirement. So you're creating a situation where the couple spend the rest of their lives on a reduced standard of living in order to pass a potentially significant asset, their home, on to their heirs. But if you factor in the potential use of a reverse mortgage to tap some of the equity in their home, you get a much higher probability that they can maintain their standard of living. We typically just assume that the home will appreciate at the rate of inflation and that the homeowner will take 50% to 70% of the value out 20 years from now, whether it's a mortgage or a reverse mortgage, and that's how we factor it in.

Let's talk specifics. What investments do you like now?

EVENSKY: ETFs [exchange-traded funds]. They're extraordinarily cost- and tax-efficient. There's one in almost every area. We use the Barclays Russell 3000 I-Share. Immensely cheap, immensely tax-efficient. Our clients own the American economy.

SIEGEL: I like dividend-paying stocks. You take a value or a dividend approach and stick with it, I think you're going to get a very good return.

DEANS: International equities are probably one of

the best values out there. I think right now there are some great values in Europe. Corporate profit growth in Europe in the first quarter is better than in the U.S. In the U.K. are some of the cheapest markets. They are trading at a 25% discount to the U.S. multiples. They have 29% profit growth, 6% top-line growth, and I think 12% or 15% gross-profit-margin improvement. Despite what's going on at the government level in Europe, European corporations seem to be becoming more focused, and they're global. If you look at their expense trends, they're actually better than those in the U.S. right now.

SINAI: For younger families looking to retirement, I would keep 100% of my money in stocks. Using index funds, I'd have a global mix: 40% in the S&P 500; 25% in emerging Asia, with China accounting for 40% of that. I'd have 15% in emerging Europe, 10% in Australia and New Zealand, 5% in Europe and 5% in the U.K.

STILLS: I'll mention three stocks that we own. J.P. Morgan, which has a 4% yield, is trading at book value—and a very low multiple of earnings. They are practically giving it away. Altria Group—Philip Morris is getting some tobacco issues behind it. It pays a nice dividend. Alliance Capital—it pays a tremendous dividend, and you get to own Sanford Bernstein, one of the top value managers in the country, as well as Alliance. Historically it's been a strong growth company, one that hopefully will come back one day.

Reading the headlines, there's a lot to worry about: rising oil prices, growing trade and budget deficits, pension plans failing, and the untold billions in Medicare and Social Security obligations. How worried are you about the chances of a total economic meltdown?

STILLS: I think we still have innovation and creativity, and with people working together, there'll be a way to get through it.

DEANS: We do worry if there could potentially be some type of dollar crisis or the bond market really reacts to a lot of what's going on, because we are very overleveraged everywhere except corporate America. But by the same token, we've been in these situations before and managed to invent our way out of it.

SINAI: If you asked me for odds, I would say there's a 5% to 10% chance of real severe distress by 2010. If you asked me, "How do you factor that into planning?" my answer is "Monitor it, watch out for it, and respond to it tactically if there are signs of a calamity." That's about all.

Any words of encouragement for people contemplating these rather daunting prospects?

EVENSKY: Think of retirement as an opportunity to explore new life options. That may include some form of job. However, with a new perspective, the job may be one of excitement, not desperation. ■

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